THE COMPASS

Third Quarter, 2003 | **A Quarterly Newsletter of Martin Capital Advisors, LLP**

INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

Post-Iraq War, economy and financial markets responding to monetary and fiscal stimuli

July 17, 2003

Second quarter stock market returns were bolstered by improving economic expectations resulting from a reduction in geopolitical tensions, most notably the quick conclusion of "major combat operations" in Iraq. Continuing improvements in fiscal and monetary conditions also contributed to increasing expectations for better times ahead. Bonds did not do as well, but achieved respectable returns as deflation fears persisted and the Fed Funds rate was cut to a fifty year low.

As we enter the third quarter, fiscal and monetary conditions are better than they have been in decades. This should result in expanding economic growth and improving stock market performance.

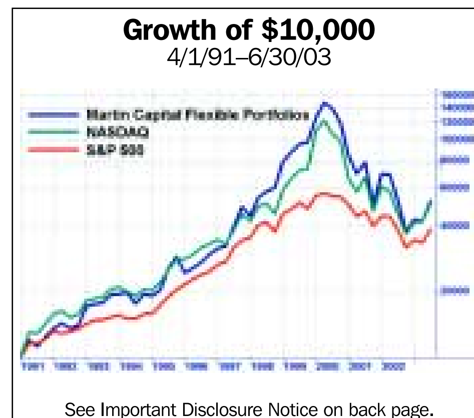
MCA Flexible Portfolios
12-month Tax Efficiency: 101.7%
(After Tax Return divided by Before Tax Return)

Interest rate sensitive securities, especially government bonds, may come under pressure as deflation fears begin to fade and inflation concerns are rekindled in the light of faster economic growth.

Although geopolitical instability will probably continue to weigh on the economy and financial markets, the amounts of monetary and fiscal stimuli already in place should more than compensate for further unrest around the world. Of course, another catastrophic event comparable to September 11th would have a negative impact on the economy and the stock market, but the effects most likely would be short-lived, similar to the quick sell-off and rebound that occurred in the fall of 2001. However, contrary to the weak economic conditions that prevailed in 2002 as a result of overblown warnings of terrorist attacks and the weapons of mass destruction hype leading up to the war with Iraq, the likelihood of additional self-inflicted disruptions is lessened as the next presidential election draws closer.

The sea change in the Fed's assessment of the potential for inflation is the most significant event for the economy and the financial markets in recent history. For the first time in fifty years the Fed is not worried about inflation. This means that the Fed will be slow to raise interest rates as the economy improves – allowing for a much higher rate of economic growth than otherwise would have been tolerated. Barring an unrelenting series of unforeseeable disasters, the Fed's extremely accommodative position should eventually result in strong economic growth and a powerful bull market.

Growth of $10,000
4/1/91–6/30/03



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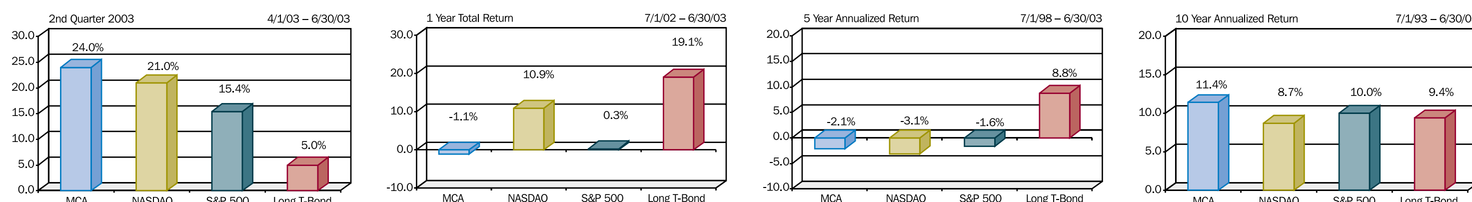
INVESTMENT RESULTS

Martin Capital Advisors Flexible Portfolios vs. NASDAQ Composite, the S&P 500 Index and the Lehman Brothers Long Treasury Bond Index



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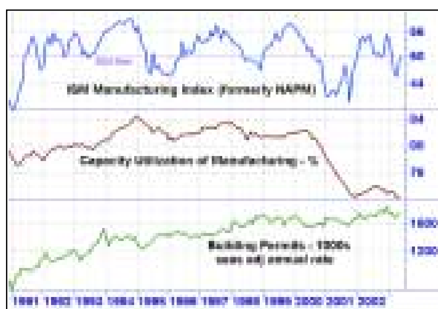
The final figure for GDP growth in the first quarter of 2003 was revised down to an annualized 1.4%, and the second quarter's growth rate will probably be 1.5% to 2.0%, not much stronger. The stock market, however, put on a great show in the second quarter, with major stock indexes rising 12% to 23%. Interest rates have declined across the yield curve, as the Fed has cut rates on the short end and the market has pulled them down on the long end. Inflation is minimal, so low in fact that that deflation has become a concern. Industry, with the exception of housing, has remained weak and shows few signs of gaining much strength. The labor market is an important part of our economy and also was showing few signs of strength by the end of the second quarter.

INDUSTRY

Conditions in the manufacturing sector were better in the second quarter, though the improvement was from weak to less weak. The ISM Manufacturing Index rose from 45.4 in April to 49.8 in June, still below the 50.0 level separating growth from contraction. New orders and inventory increased in June, while employment declined. Total capacity utilization was 74.3% in April and May, the lowest since 1983. Capacity utilization of manufacturing was even lower, 72.5% and 72.6% in those two months, also representing 20-year lows. Historically, 80% to 82% has been regarded as being a good level of capacity utilization where not much equipment or too many facilities are idle and at the same time no inflationary bottlenecks are occurring. The auto industry in the US Midwest is reporting unutilized capacity of over 20%, unusually high for that type of manufacturing.



The homebuilding industry continued to lead the rest of the economy, buttressed by low mortgage rates. Building permits and housing starts remained strong through May with no signs of any slowing. As long as mortgage rates remain near 40-year lows this industry will continue its strong performance.

SALES

Consumer spending has continued to be the driving force behind our economy, while business spending has hardly picked up from recession levels. Retail sales have remained relatively strong, up only 0.1% in May, but showing a respectable 5.1% gain in 12 months. Though volatile, retail sales have been generally improving since early 2002. Auto and light truck sales have put in a strong, though volatile performance for the past two years. June's sales at an annual rate of 16.4 million were better than any months between 1987 and 1998. Car manufacturers have been offering strong incentives like zero-interest financing to potential buyers for the past 20 months, so it remains to be seen how sales will hold up when these giveaways are no longer available. New home sales hit an all-time high of an annualized 1.157 million units in May. Mortgage rates have fallen lower and lower, making homes more and more affordable, so more buyers continue to come forward to take advantage of the situation. As long as rates stay low, these sales will continue at near-record levels. Unfortunately, business spending is what is not happening today; pessimism about the direction of the overall economy has caused many businesses to cut spending to the bone. That pessimism must be altered before we begin to see the expansion and job creation that our economy sorely needs.

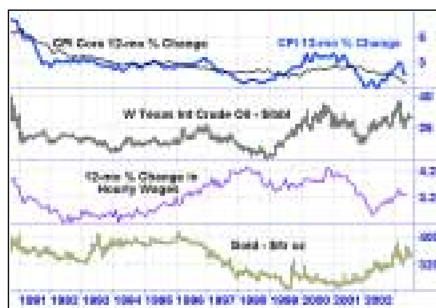
LABOR

The labor market is the most important weak spot in our economy today. The unemployment rate rose to 6.4% in June, the highest since 1994, when we were experiencing a slow recovery from a previous recession. Two things need to be mentioned about this: the unemployment rate is a lagging indicator that shows where we've been, not where we're going and 6.4% is not a high rate by historical standards prior to about 1994. Nevertheless, it's a negative indicator of current conditions. Our economy experienced a net loss of 122,000 jobs in the second quarter, more than the 114,000 lost in the first, though the monthly trend appears to be improving, with smaller losses each month than early in the year. The average of weekly initial unemployment claims was 435,000 in the second quarter compared to 406,000 in the first, marking deterioration in a leading indicator. The monthly average in June was 424,000, well above the 400,000 figure marking stability. The middle chart shows claims as a percent of total jobs, as the labor force is larger today than it was at the beginning of the period shown. The average numbers of hours worked slipped to 33.7 for the entire second quarter, equal to the lowest in over 40-years. The average weekly hours worked in manufacturing, another leading indicator, was 40.2 in June, low, but not so extreme in historical terms. Only one indicator of labor conditions shows improving conditions: the

Challenger Report of large corporate layoffs fell to 59,715 in June, the lowest such number since November 2000. By comparison, the worst such number was 248,332 in September 2001. Taken all together, the numbers show weak labor market conditions with few signs of improvement.

INFLATION

Inflation is not a problem in our economy today, while its opposite, deflation, is considered to be a threat. Our inflation rate measured by the 12-month change in the Consumer Price Index, is 2.5%, while the core rate, which excludes food and energy, is 2.1%. The rate based on the CPI is down from 3.0% in February and March, while the core rate is up from a 38-year low of 1.4% in April. Fears of deflation have arisen from an extended slowdown in the world economy and the lack of a strong recovery by the US economy from the last recession. Just as economic growth that is too fast will eventually create inflation, growth that is too slow has a tendency to be deflationary. Ironically, some of the factors that were beneficial in helping subdue inflation in the past like gains in productivity and globalization are now potentially harmful as they push in the direction of deflation. Another deflationary factor cited above is low capacity utilization. Looking at some of the most important individual factors and prices, the connection between our CPI-derived inflation rate and the price of oil on the top two charts is striking. The price of oil is projected to decline, as Iraqi oil comes back on line, along with increased production in Nigeria and Venezuela. Hourly wages are important because two-thirds of



inflation is said to be due to labor costs. That trend was down until early 2002, when it reversed. Gold is both an indicator of the valuation of the dollar and of inflation. Today, the weaker dollar is more responsible for higher gold prices than the expectation of inflation.

SUMMARY AND OUTLOOK

Two key questions are being asked today. Will economic growth accelerate in the last half of 2003? And will the prospects for deflation diminish? The answers are tied together because faster growth will push back the danger of deflation. Some compare our situation today with the early days of the depression of the 1930s, but there is a big difference. After the stock market crash of 1929, the Fed continued with a tight monetary policy, essentially strangling our economy. Today, the Fed has made it clear that it intends to fight deflation with loose monetary policy, using all the tools at its disposal. It has already cut short rates to near zero and it can also buy US bonds on the open market and drive down long interest rates, something it has not done before. Furthermore, the Fed has made it clear that it will not take away the punch bowl immediately when the economy picks up and the party starts to get lively. Some indications in the financial markets point to improved growth: the continuing stock market rally and the increase in long interest rates over the past two weeks. The stock market tends to look out something like six months in the future, so if that indication is correct about the future, we should see the economy much stronger by the end of the year. Bond yields tend to rise mainly from two expectations: an increase in inflation, which is not bad news at this point, and an increase in economic activity and demand for loans, which is good news. Though these indications are not always right, at least they are pointing in a good direction. Geopolitical events have calmed down and now it is business confidence rather than consumer confidence that must improve. What is needed more than anything else to get our economy moving is for businesses to get past the prevailing pessimism and be willing to spend for expansion and hiring.

MARKET AND ECONOMIC STATISTICS

as of Market Close June 30, 2003, with 3-month and 12-month changes

LABOR – Jun '03		3 mo	12 mo
Unemployment Rate	6.4%	0.6%	0.6%
New Non-Farm Jobs	–30K	–122K	–421K
Avg Hourly Wages	15.38	0.6%	3.0%
Avg Init Unempl Clms	328K	+1K	+33K

STOCK INDICES*		3 mo	12 mo
Dow Industrials	8985	12.4%	–2.8%
S&P 500	975	14.9%	–1.5%
NASDAQ Comp	1623	21.0%	10.9%
NASDAQ 100	1202	18.0%	14.3%
NYSE Comp	5505	16.4%	–2.3%
Wilshire 5000	9343	16.0%	–0.4%
Russell 2000	448	23.0%	–3.1%

*excluding dividends

INTEREST RATES		3 mo	12 mo
91-day T-Bill DR	0.86%	–23.2%	–49.1%
30-yr T-Bond Yld	4.55%	–5.8%	–17.4%
FNMA 30yr mortg	5.03%	–7.5%	–22.4%
Prime Rate	4.00%	–5.9%	–15.8%
Fed Funds Trgt	1.00%	–20.0%	–42.9%
Fed Disc Rate	0.50%	–33.3%	–60.0%
S/L Long T-Bnd Ind	12374	5.0%	19.1%

PRICES, INFLATION		3 mo	12 mo
CPI, May	183.3	0.0%	2.1%
PPI, May	141.9	–0.8%	2.5%
Gold, cash	346.4	2.7%	8.8%
W Tx Int Cr Oil	30.18	–2.7%	12.3%
Copper, cash	0.75	5.0%	–2.5%
CRB Futures Ind	233.8	0.7%	11.7%
CRB Raw Indust	259.5	0.6%	4.9%

MONEY		3 mo	12 mo
M2, Bil Curr$, May	5999	2.1%	7.9%
Free Reserves	1353	–17.0%	23.0%
Money Mkts-Bil$	2218	–2.3%	–1.4%
US $$$ Index	94.7	–4.2%	–10.8%

INDUSTRY		3 mo	12 mo
ISM Index, Jun	49.8	3.6	–5.4
Indus Prod Ind, May	109.6	0.3%	1.7%
Cap Utiliz, May	74.3%	0.0%	0.5%
Bldg Permits, May	1788K	2.8%	1.1%

1st Qtr. '03	Final	3 mo	12 mo
GDP-Bil$	9552	1.4% apr	2.0%
GDP Deflator	111.9	2.4% apr	1.6%
Empl Cost Index	164.5	1.3%	4.0%
NF Productivity	124.8	1.9% apr	2.4%

MARKET TIMING VIEWPOINT

Recommended Tactical Asset Allocation

Stocks	130%	Δ	–5%
Bonds	0%	Δ	0%
Cash	–30%	Δ	+5%

Performance Expectation

	June 2004		*June 2008*	
	Target	Total Return	Target	Total Return
S&P 500	1200	+25%	1850	+110%
NASDAQ	2100	+30%	4000	+150%
30-Yr. T-Bond	5.25%	– 15%	5.0%	+ 20%

A Quarterly Publication of
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Martin Capital Advisors, LLP, is a registered investment advisor managing private and institutional investment portfolios, mutual funds and hedge funds. Independent CPA performance review available on request.

FLEXIBLE PORTFOLIO TOP 20 POSITIONS

1	Dell Computer	31.84	6	Charles Schwab	10.09	11	Intel	20.81	16	Bear Stearns	72.42
2	Whole Foods Market	47.53	7	Williams-Sonoma	29.20	12	Microsoft	25.64	17	Citigroup	42.80
3	Applied Materials	15.84	8	Cisco Systems	16.79	13	Nasdaq 100	29.95	18	Home Depot	33.12
4	Electronic Arts	73.90	9	Oracle Systems	12.01	14	Starbucks	24.55	19	Medtronic	47.97
5	Tiffany	32.68	10	SPDR Trust	97.63	15	Texas Instruments	17.60	20	Centex	77.79

COMPARISON OF INVESTMENT RESULTS

Performance of Relevant Indexes

	Martin Capital Advisors[1]	Dow Jones Industrial Avg.	S&P 500 Index	NASDAQ[2]	Wilshire 5000 Index	Long-Term T-Bond Index	Money Market Avg. Yld.	Consumer Price Index
1991	+33.9%	+24.5%	+30.6%	+56.9%	+34.2%	+18.5%	+5.2%	+3.1%
1992	+26.8%	+8.0%	+7.7%	+15.5%	+9.0%	+8.0%	+3.3%	+2.9%
1993	+14.5%	+18.1%	+10.0%	+14.8%	+11.3%	+17.3%	+2.7%	+2.7%
1994	–2.1%	+5.9%	+1.3%	–3.2%	–0.1%	–6.9%	+3.8%	+2.7%
1995	+27.5%	+36.9%	+37.6%	+40.0%	+36.5%	+30.7%	+5.5%	+2.5%
1996	+29.4%	+29.1%	+23.0%	+22.7%	+21.2%	–0.8%	+5.0%	+3.3%
1997	+41.4%	+24.9%	+33.4%	+21.6%	+31.3%	+15.1%	+5.1%	+1.7%
1998	+78.8%	+18.1%	+28.7%	+39.6%	+23.4%	+13.5%	+5.0%	+1.5%
1999	+58.2%	+27.2%	+21.0%	+85.6%	+23.6%	–8.7%	+4.9%	+2.6%
2000	–33.0%	–4.9%	–9.1%	–39.3%	–10.9%	+20.1%	+5.8%	+3.2%
2001	–17.4%	–5.4%	–11.9%	–21.2%	–11.0%	+4.6%	+3.8%	+1.9%
2002	–38.3%	–15.1%	–22.1%	–31.5%	–20.9%	+17.2%	+1.1%	+2.3%
2003	+20.9%	+9.0%	+11.8%	+21.5%	+12.9%	+6.2%	+0.7%	+1.0%
Total[3]	+418.5%	+365.4%	+289.3%	+334.1%	+281.9%	+237.3%	+65.4%	+36.6%
Avg.[4]	+14.1%	+13.1%	+11.5%	+12.5%	+11.3%	+10.2%	+4.1%	+2.5%

[1]Total Annual Performance, net of commissions, fees, and expenses, of all Martin Capital Advisors flexible investment portfolios. Audited 1991-99 by Carpenter & Langford, P.C., Certified Public Accountants. [2]Without dividends. [3]Total compounded return, including reinvestment of dividends and interest. [4]1991-2003 annualized return.

IMPORTANT DISCLOSURE NOTICE: Past performance does not guarantee future results. Figures include the reinvestment of all dividends received and reflect cash and cash equivalents. The volatility of the Flexible Portfolios may differ from that of the benchmark. From time to time, portfolio performance may reflect the use of margin investing as well as material investments in bonds or cash. The manager will utilize stocks, bonds and cash in an attempt to enhance returns. The Flexible Portfolio average represents 49 individual portfolios and 57.3% of all funds under management by MCA on 6/30/03. Clients explicitly elect this management style on their personal data form. The Flexible Portfolios are tactical asset allocation investment accounts containing stocks and bonds that are managed with a view toward capital appreciation.

INVESTMENT PHILOSOPHY

Our investment approach recognizes that to achieve long-term, superior performance, there must be an acceptance of some short-term risk. We then consider fundamental and technical factors in determining a prospective investment's risk-reward ratio. We also evaluate social issues, such as environmental policies and employee relations, as part of our investment assessment.

Overall market risk is considered in the timing of investments and implementation of hedging strategies. We seek to maximize portfolio performance and manage volatility by reducing investment exposure during periods of apparent high market risk, while increasing investment commitment during periods of apparent lower risk.